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Forbes

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Number 4

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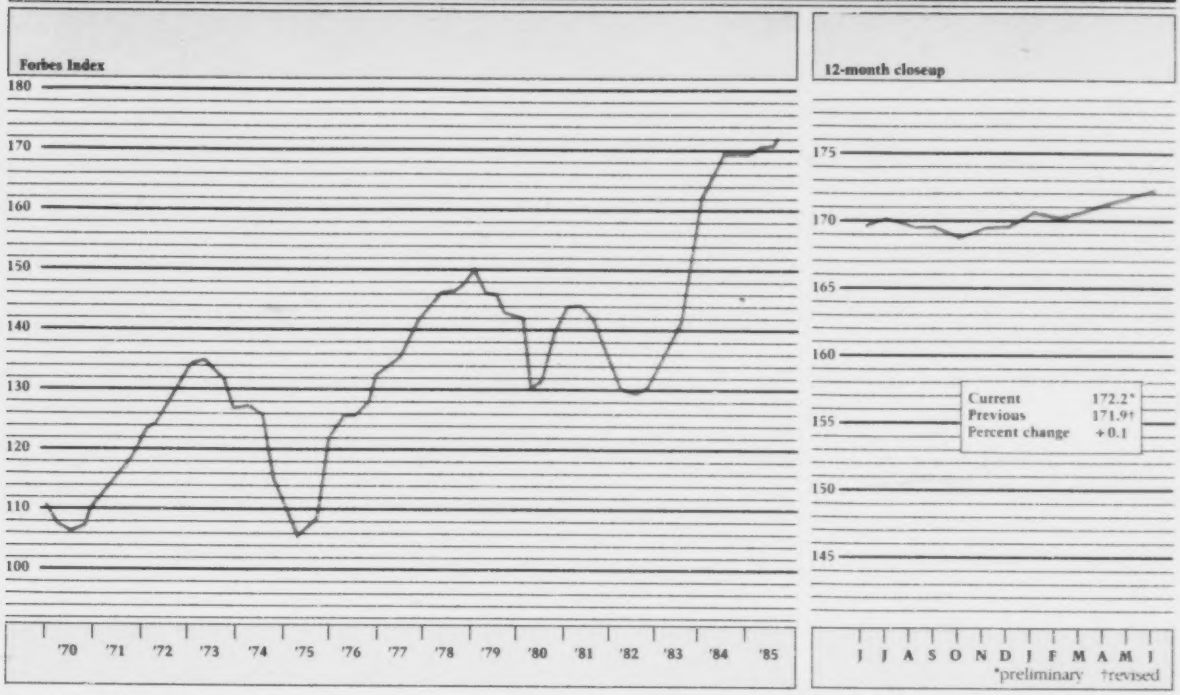
Cover illustration by Robert Grossman

The Forbes Index

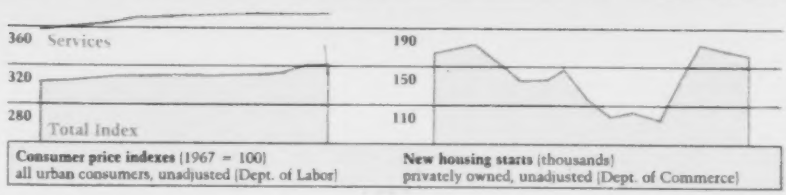


Weakness shows through. Despite lower mortgage rates, new housing starts fell for the second consecutive month, this time by 3.8%. Retail sales also fell for the second straight month. The final bit of bad news came from new unemployment claims, 3.3% higher than they were one month earlier. All of this fits in with a slack economy that grew at an annual rate of only 1.7% in the second quarter. But while most Forbes Index components are trending downward, a few pockets of strength hold it up. Personal income rose 0.7% over the previous month. And industrial production—now being calculated using 1977 rather than 1967 as the base year—is up nearly 0.2% from month-earlier figures. Our preliminary figure shows the Forbes Index with a 0.1% gain in the latest period.

The Forbes Index Components

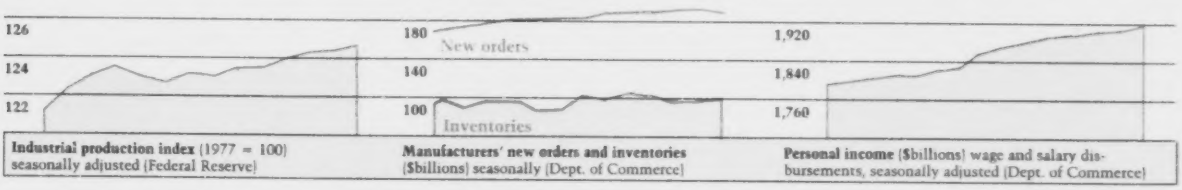
The Forbes Index is a measure of U.S. economic activity composed of eight equally weighted elements: Total industrial production, new claims for unemployment compensation, the cost of services relative to all consumer prices, the level of new orders for durable goods compared with manufacturers' inventories, total retail sales, new housing starts, personal income, total consumer installment credit.

To measure these eight elements, FORBES monitors ten series of U.S. government data. The last 14 months' data for each series are presented at right.



Consumer price indexes (1967 = 100) all urban consumers, unadjusted (Dept. of Labor)

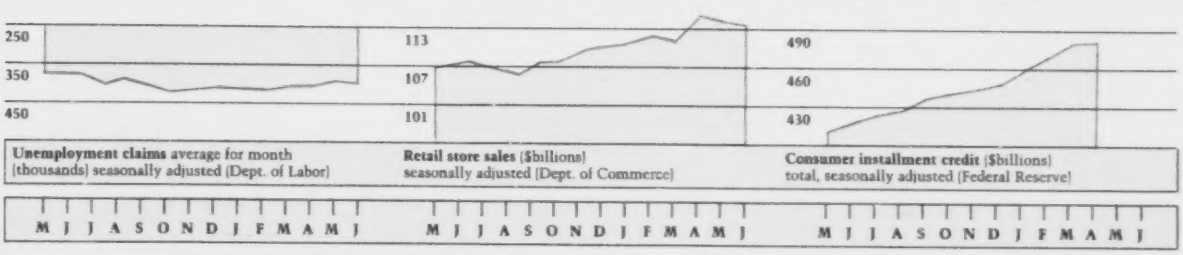
New housing starts (thousands) privately owned, unadjusted (Dept. of Commerce)



Industrial production index (1977 = 100) seasonally adjusted (Federal Reserve)

Manufacturers' new orders and inventories ($billions) seasonally (Dept. of Commerce)

Personal income ($billions) wage and salary disbursements, seasonally adjusted (Dept. of Commerce)



Unemployment claims average for month (thousands) seasonally adjusted (Dept. of Labor)

Retail store sales ($billions) seasonally adjusted (Dept. of Commerce)

Consumer installment credit ($billions) total, seasonally adjusted (Federal Reserve)

Forbes

UAL Inc. has moved fast on several fronts, leaving Wall Street anxiously crunching new numbers. But the moves make sense, and add up to a more profitable future.

Ready for takeoff

By Howard Banks

UAL INC., THE PARENT company of United Air Lines, the U.S.' largest airline, has seemed to be calamity's child. Misfortunes, from groundings of the DC-10 through labor problems, have dogged its progress and its profitability. In only one of the last six years has its return on capital gone above 10%. This year it endured a 29-day pilots' strike, one effect of which will be to all but wipe out aftertax earnings for 1985.

Same old story? Anything but. Not only did UAL get a labor agreement after that strike that will have extremely positive long-term consequences, but the company has also made a series of lightning moves in recent months that, taken together, should bring profits more in line with UAL's considerable potential.

If the moves seemed hurried, it's because company officials had reason to believe that somebody else had already noticed UAL's potential. Stock transactions showed someone was accumulating a position. Now, says John L. Cowan, UAL's executive vice president for finance, "We've probably removed UAL entirely from a takeover threat. But what happened helped accelerate things that were on the drawing board for years." Here's what cleared the backlog.

In June UAL announced a $588 million purchase of Hertz Corp. The acquisition had less to do with the marketing "synergy" that most Wall Street comment has focused on—passengers checking their bags with United and being able to transfer them to the trunk of a Hertz car or, perhaps, a room in one of UAL's chain of Westin Hotels. More important, says UAL Chairman Richard Ferris, are the potential operational links. Hertz, like United and Westin, sells a perishable consumer good. An unsold seat or bed or an unrented automobile is lost forever; none of them can be put in inventory.

Steve Smith/Wheeler Pictures

UAL Chairman Richard Ferris
Quietly confident.

It's the airlines—especially United, with its Apollo reservations system, and key competitor American Airlines, with Sabre—that lead the way in using computers to reduce empty seats or rooms or idle automobiles through timely fare or rate discounts. The synergy, in other words, comes through shared communications.

In April UAL announced the purchase of Pan American's profitable Pacific routes. The $715 million price is high, especially considering that many of the aircraft that come with the deal will have to be replaced. But it's the most economical way to build an instant system in the Pacific, the fastest-growing international air market.

In September, UAL has announced, it will deal some of its Westin Hotels to the public. The group of 51 hotels is an asset-rich jewel. So Ferris plans to extract some of the equity through selling limited partnerships. In September a package of three as yet unnamed hotels will be sold to the public for $360 million through Merrill Lynch in partnerships worth around $10,000 apiece. United gets the money, retains the profitable management contract and, in ten years or so, shares 50-50 with the limited partners any equity appreciation that occurs in the meantime. "It's a way for a public company to get at equity and future growth in its real estate as well as operational earnings," says Ferris. If it works well, a second partnership will be sold for another $300 million-plus early in 1986.

Those were the announced moves. What UAL hasn't talked about, but is well pleased with, is the labor agreement concluded in mid-June. New hires are on a 40% lower pay scale for the first 5 years. For years 6 to 12, pay will be set through arbitration but must be tied to the pay of pilots at the airline's four main competitors. Today that's mostly American and Continental, both with tight, two-tier pay scales. It will be the same process for years 13 through 18 for all pilots hired from now on. The pay of these new hires merges with that for existing pilots only when the new ones reach captain's rank. At United, says Ferris, that takes around 18 years.

Now that United has a competitive labor deal with its pilots, it can afford to buy more equipment. It was already adding 5% to 6% capacity cheaply with 30 secondhand aircraft costing $400 million. "With fuel prices falling, used are the most efficient buy," says Ferris. But such deals are getting scarce. And Ferris will be ordering a raft of new aircraft this fall from Boeing, which has a $75 million chain around United's neck. Back in 1979

Room to maneuver

Some myths, however wrong, persist against all evidence. Typical is the notion that airline deregulation will lead inevitably to oligopoly, to an industry dominated by three or four giant airlines.

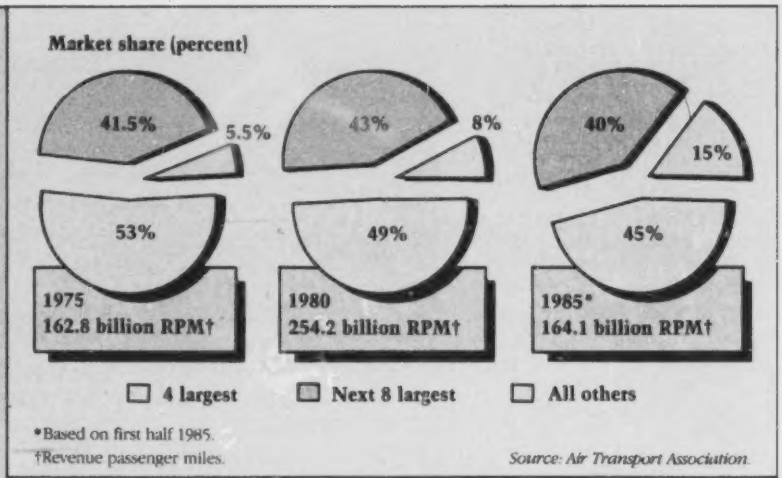
The chart at right shows what has actually happened in the airline business since deregulation in 1978. The market share (percentage of passenger traffic carried, measured by revenue passenger miles) of the four biggest carriers has steadily slipped, while the share of the next eight largest has stayed roughly the same. It is the smaller scheduled jet airlines—formerly called regional carriers—that have grown fastest.

Some things such a chart cannot show. There have been significant changes in the standings. Leaving aside the effect of the recent strike, United remains top dog, but archrival American has grown to be clearly number two. Postbankruptcy Braniff is relegated to the also-rans, while upstart People Express (though under pressure on the profit front) in traffic terms is now tenth-largest.

A merged TWA, with Continental or Eastern, would move to the top but would not create oligopoly. One of the other 100-odd jet carriers would move up a notch.

One caveat: The bigger carriers, led by United and American, have learned to use the marketing muscle of their computer reservation systems, despite official restraints that have been imposed. Increasingly, small carriers operate in the knowledge that they will be trampled if they become overambitious.

The likes of People Express will have to watch their toes.—H.B.



*Based on first half 1985.
†Revenue passenger miles.

Source: Air Transport Association.

United ordered 39 of the new medium-range 767s off the drawing board. The airline took the first 19 and doesn't want or need many of the next batch of 20, but there are penalty clauses. The ex-Pan Am routes will need new 747s, and Boeing would like to sell some interim short-haul aircraft, like 737-300s. A painless swap seems likely.

UAL's financial position will remain sound even after all these deals. In September or October, Cowan says, UAL will buy annuities and thereby recover a little over $1 billion from its pension fund. Debt after all deals are completed will be under 30% of capitalization. Hertz will also give UAL a sizable cash flow boost, raising it, says analyst Michael Derchin of First Boston, to well over $1 billion a year. "So much has happened in a hurry at United, Wall Street doesn't appreciate them," says Derchin. "Just look at United's and American's market capitalization." Recently, American's was around $3 billion, and United's, fully diluted, was around $2 billion. If it got the market acceptance of its rival, UAL would sell at roughly 86 a share, whereas it now sells at around 55. Derchin, who thinks UAL earnings will hit 10 to 12 in 1986, sees no reason for the market capitalization gap.

And Ferris & Co. surely see no reason for it at UAL's quietly confident Chicago headquarters. ■

Secondary markets in residential mortgages are booming. But underlying it all is a loan on a frame house on Main Street. And the foundation is shaking.

Trouble at home

By Richard L. Stern and Mark Clifford

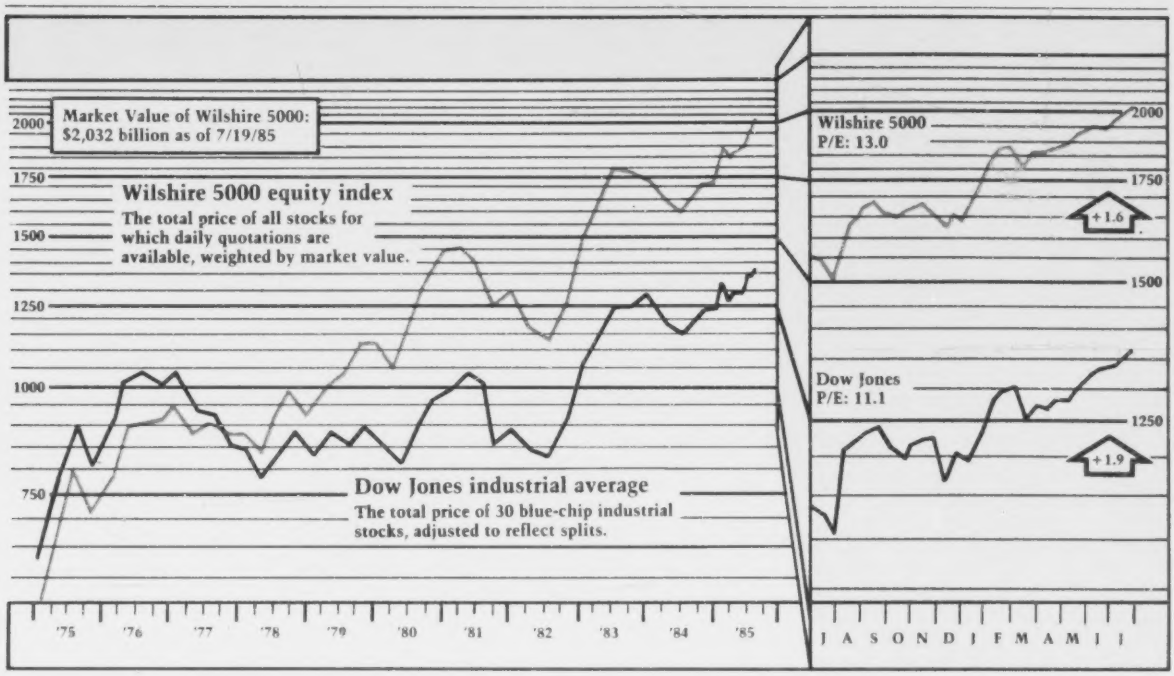
THERE ARE SIGNS OF REAL trouble in the single-family home mortgage market that could have serious repercussions for many lenders, insurers, the federal government and the exploding market for mortgage securities.

In what has always been regarded as the safest kind of loan, indeed the nation's prime credit, one hears more and more of outright fraud.

In Camden, N.J. a vice president of Margaretten & Co., a mortgage banking subsidiary of Berg Enterprises, Inc. (which recently was acquired by American Can), was sentenced in July to a year in jail in a fraud involving mortgages insured by the Federal Housing Administration (FHA). It was not an isolated incident. There's growing evidence that similar frauds in FHA- and Veterans Administration-guaranteed mortgages are occur-

The Forbes/Wilshire 5000 Review

Edited by Steve Kichen



Two trillion dollars. That's a new record value for stocks used in the Wilshire 5000 index, which tracks all common stocks traded on the NYSE, AMEX, Nasdaq and regional exchanges. The total first broke $1 trillion in February 1972. After peaking the following December, it fell as low as $550 billion in September 1974. The $1 trillion level was not reached again until August 1978. Since then, however, the total capitalization of the 5,500 stocks in the Wilshire has doubled. ("Total return" performance has been even better, since it includes dividends.) Compare the Dow, which says that the market went up only 55%.

In reaching its milestone, the Wilshire recorded a 1.6% two-week gain as the rally broadened, with both the Nasdaq and Amex outscoring the NYSE. What distinguishes this rally from its 1982-83 predecessor—so far—are its steady but comparatively moderate day-to-day advances.

Closeup On The Equity Markets

Performance of six leading indexes

Percent change	Wilshire 5000	Forbes 500[1]	Dow Jones industrials	NYSE Composite	Amex Market Value Index	NASDAQ Composite
in last 4 weeks	3.6	3.5	2.7	3.1	4.9	6.6
in last 52 weeks	32.2	33.4	23.4	31.4	23.9	34.2

Stock performance based on six key investor yardsticks

Percent change	Company size		Volatility[2]		P/E multiple		Dividend yield		Growth profile[3]		Share price	
	large	small	high	low	over 25	under 5	over 7.5%	none	high	low	over $40	under $4
in last 4 weeks	3.7	4.4	7.1	3.6	6.2	4.5	3.1	5.6	6.5	3.7	4.8	3.7
in last 52 weeks	38.7	25.5	34.1	43.4	22.4	43.8	40.2	32.6	28.4	40.9	43.6	12.6

[1]Based on sales.
[2]A stock's sensitivity to overall market movement. High-volatility issues have wide price fluctuations, low-volatility issues are more stable.
[3]A quantitative evaluation of a stock's growth image, determined by Wilshire Associates.

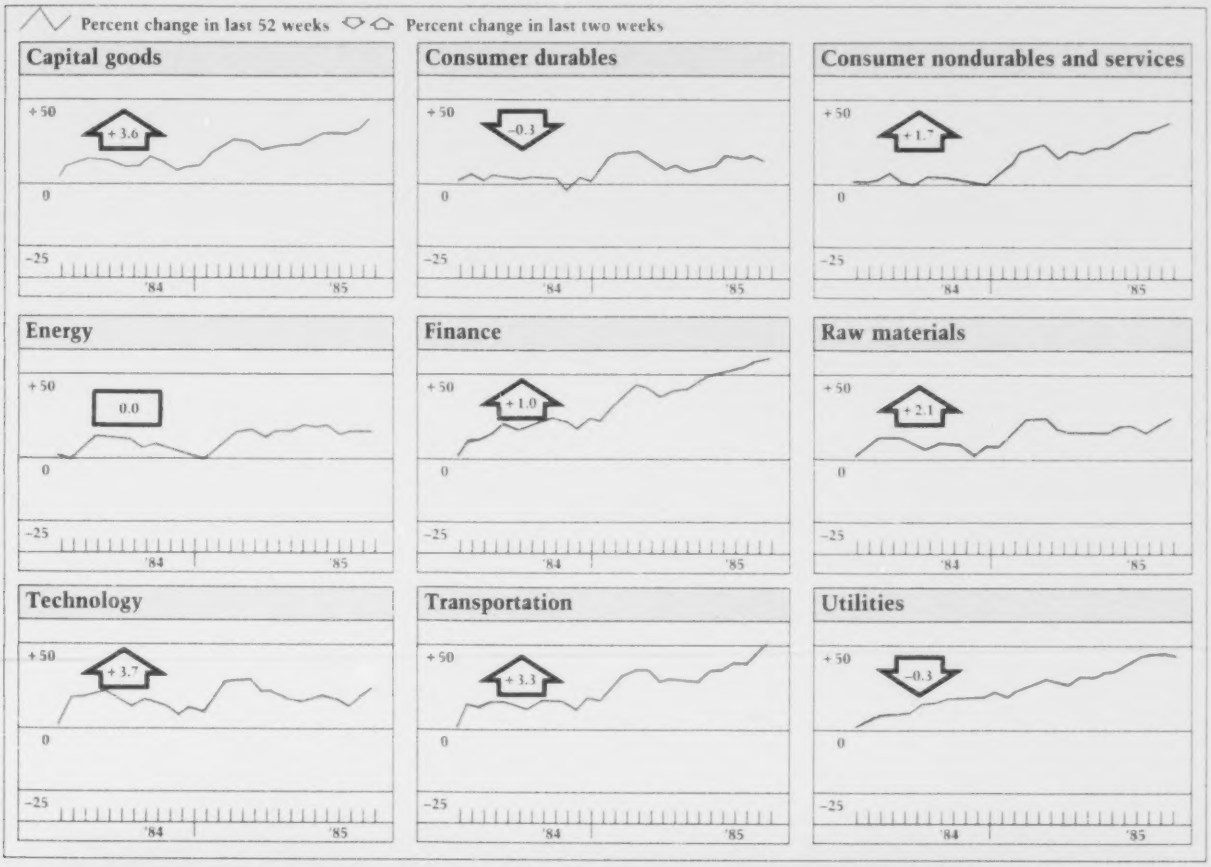
Note: All data for periods ending 7/19/85. Prepared by Wilshire Associates, Santa Monica, Calif.

Where The Action Is

Is the play in utilities over? Two weeks ago utilities were second only to finance shares in 52-week performance. If interest rates have had their big tumble, however, investors may feel that these conservative shares have already had their run. Over the last two weeks utilities fell 0.3%, and slipped to fourth place in 52-week performance.

Contrast technology—it's one of the worst sectors in 52-week performance, yet it outposted the other groups with a 3.7% two-week gain. But don't read turnaround too hastily. The problems plaguing the computer industry are not likely to disappear soon.

Oils have been another weak group over the past year, with only a 10.5% increase. That may allure contrarian investors to these shares.



What The Analysts Think

Where are the bargains? Over the last two weeks The Forbes Sales 500 gained 1.8%, while analysts made slight downward adjustments in 1986 earnings projections. That puts the Sales 500s at 9 times estimated 1986 earnings. How much more will investors be willing to pay for these shares if estimates continue to fall?

Forecasting the Forbes 500

Performance period	Average earnings per share	P/E
latest 12 months	$3.48	11.9
1985 estimates	3.99	10.3
1986 estimates	4.57	9.0

Rank based on change in estimate	Sector	Estimated 1985 EPS	Estimated 1985 P/E	% change in 1985 estimate in 2 weeks	% change in 1985 estimate in 4 weeks
1	Energy	$3.45	8.4	0.59%	0.21%
2	Finance	3.29	10.5	0.43	0.61
3	Utilities	3.40	8.4	-0.15	-0.23
4	Consumer nondurables	2.47	13.3	-0.17	2.59
5	Consumer durables	4.73	7.8	-0.94	-0.93
6	Transportation	2.78	10.5	-1.09	-2.62
7	Capital goods	2.76	11.8	-1.23	-2.51
8	Technology	2.61	13.2	-1.39	-3.82
9	Raw materials	2.03	13.0	-1.64	-4.22

Earnings projections are capitalization-weighted consensus estimates from over 2,000 security analysts. Data are compiled and updated continuously by the Institutional Brokers Estimate System (IBES), a service of Lynch, Jones & Ryan, a New York-based brokerage firm.

Note: All data for periods ending 7/19/85. Prepared by Wilshire Associates, Santa Monica, Calif., IBES, a service of Lynch, Jones & Ryan, New York.

The Forbes/TUCS Institutional Portfolio Report

Edited by Steve Kichen

INSTITUTIONAL INVESTORS made good money in the second quarter but they failed to outperform the market, according to data generated by the Trust Universe Comparison Service. TUCS, maintained by Santa Monica, Calif.-based Wilshire Associates, monitors more than 4,000 pension portfolios, a sample that represents approximately 20% of the estimated $1.3 trillion total U.S. pension assets. The findings: Institutions scored a median total return from all their investments of 7.4% in the second quarter. From equities alone, they earned 7.3%, compared with a 7.5% total return for the Wilshire index. The individual investor, it seems, isn't so dumb after all.

A strong market enabled pension sponsors to continue treating their funds as cash kitties. Many employers are cutting back contributions, and some are recapturing past contributions by terminating their benefit plans. The net result is that pension assets diminished in the quarter once price appreciation and dividends were backed out. (See "Segment performance and cash flows" in the table at right, showing a 5.1% decline in assets under management.) By the same calculations only the convertible segment, with a 2.4% gain during the last quarter, shows an inflow of money.

Cash fell from 10.9% to 10.4% of the typical pension portfolio. That may not sound like much, but it means that managers in the sample moved $1.6 billion in assets from cash to somewhere else. TUCS says that its universe still holds $33 billion in cash and cash equivalents. With equity and fixed income recently returning three to four times as much as cash, managers are going to be tempted to shift still more cash elsewhere.

The new section below, "How different managers performed," shows that the most successful managers in the last three months were those who specialized in so-called value, or high-yield, stocks. Second place goes to sector rotators—managers who buy and sell according to forecasts for economic sectors. The most successful sector rotators bought the utilities, which rose 12.3% last quarter, and avoided technology shares, which gained only 0.4%. Meanwhile, managers who emphasized market timing underperformed the Wilshire by a wide margin last quarter, with only a 5.9% total return. Over the last 24 months, however, managers of emerging growth portfolios have had the worst record: a 5.3% total return, compared with 19.8% for the Wilshire index.

Where the institutions put their money

Segment	—Portfolio weighting— most recent quarter	previous quarter
Equity	56.8%	56.6%
Fixed income	28.1	27.5
Cash and equivalents	10.4	10.9
Convertibles	0.9	0.9
Other[1]	3.8	4.0

Equity portfolio characteristics

	Institutional portfolios	Wilshire 5000
Price/earnings ratio	11.7	11.4
Dividend yield	3.8%	4.0%
Beta[2]	1.06	1.04
Price/sales	1.06	1.02
Price/book	2.09	2.05

Segment performance and cash flows

Segment	—Most recent quarter— median total return	shift in institutional holdings	——Latest 12 months—— median total return	shift in institutional holdings
Equity	7.3%	–0.6%	29.8%	–1.3%
Fixed income	8.4	–1.1	28.7	–0.8
Cash equiv	2.1	–1.1	10.0	–19.1
Convertibles	7.5	2.4	28.9	0.7
Other[1]	2.5	–2.2	3.0	–9.6
Total	7.4	–0.9	26.7	–5.1

How different managers performed

Manager style	Total return recent quarter	12 months	24 months
Diversified	6.8%	22.0%	18.7%
Growth	7.2	22.5	7.1
Growth—Emerging	7.8	20.2	5.3
Market timer	5.9	19.1	10.9
Sector rotator	7.9	25.0	8.4
Value	8.5	25.7	22.7

Position changes: These securities had the greatest relative change in holdings over the last quarter

Security	Increase in holdings	Total quarter return	Security	Decrease in holdings	Total quarter return
Exxon	0.6%	9.0%	American Exp	–0.4%	15.6%
Xerox	0.4	23.0	American Brands	–0.3	–2.5
AT&T	0.3	12.9	Fed Dept Strs	–0.2	15.4
Reynolds Inds	0.3	–6.2	Waste Mgmt	–0.2	14.0
Dart & Kraft	0.3	15.7	Philip Morris	–0.2	–7.5
FPL Group	0.3	11.2	Toys 'R' Us	–0.2	31.1
FW Woolworth	0.2	14.5	General Re	–0.1	15.8
Anheuser-Busch	0.2	19.8	UAL	–0.1	16.6
Sears, Roebuck	0.2	13.7	Loews	–0.1	13.4
Bell Atlantic	0.2	13.5	Wal-Mart Stores	–0.1	22.6

[1]Real estate, foreign investments, venture capital, guaranteed insurance contracts.
[2]A measure of risk. A stock with a beta of 1.00 tends to move up or down at the same rate as the S&P's 500.
Note: Data for quarter ending 6/28/85. Prepared by the Trust Universe Comparison Service (TUCS®), a service of Wilshire Associates, Santa Monica, Calif.

Where the institutions are—and aren't

Most overweighted relative to Wilshire 5000			Most underweighted relative to Wilshire 5000		
	% of			% of	
Security	institutional universe	Wilshire 5000	Security	institutional universe	Wilshire 5000
SmithKline Beckman	0.6%	0.2%	Exxon	1.4%	2.1%
McDonald's	0.6	0.3	IBM	4.0	4.4
Citicorp	0.6	0.3	Phillips Petroleum	0.0	0.4
Phibro-Salomon	0.6	0.3	Procter & Gamble	0.3	0.6
Lockheed	0.5	0.2	Standard Oil of Ohio	0.3	0.6
AMR	0.4	0.1	AT&T	0.9	1.2
Chrysler	0.5	0.2	Eastman Kodak	0.5	0.7
Tandy	0.4	0.1	General Electric	1.3	1.5
Xerox	0.4	0.2	Sun Co	0.1	0.3
JP Morgan & Co	0.4	0.2	Minnesota Mng & Mfg	0.4	0.5

Utilities—an institutional fad. With interest rates falling, the normally staid utility stocks have been hot performers of late. This has not escaped pension fund managers, who have helped push up utility shares by buying them heavily. In the June quarter utility holdings rose from 8% to 11.7% of the TUCS equity portfolio. Technology and consumer nondurable shares were sold off.

Energy stocks continue to be the most underweighted in institutional portfolios relative to the Wilshire 5000 composite. However, while Exxon is still the most underweighted of all firms, it now leads the list of securities with the greatest relative increase in holdings over the last quarter, as shown in the "Position changes" table on the previous page. This could be the beginning of a promising trend for individual investors who have waited patiently for a turnaround of major oil stocks.

Sector activity and top holdings

% of institutional portfolio: most recent quarter previous quarter

Capital goods	5.3%	5.3%	Consumer durables	4.8%	4.5%	Consumer nondurables	27.6%	29.2%
	total return			total return			total return	
General Electric	5.6%		General Motors	–0.4%		Sears, Roebuck	13.7%	
Westinghouse Electric	15.7		Ford Motor	8.0		Philip Morris	–7.5	
Emerson Electric	5.4		Chrysler	5.4		American Home Prods	4.1	
Caterpillar Tractor	3.5		Goodyear Tire & Rubber	11.3		SmithKline Beckman	10.6	
Eaton	0.2		RCA	15.8		McDonald's	16.0	
Energy	9.9%	9.3%	Finance	11.9%	12.9%	Raw materials	10.4%	10.8%
	total return			total return			total return	
Exxon	9.0%		Citicorp	15.5%		El du Pont de Nemours	13.5%	
Atlantic Richfield	24.5		Phibro-Salomon	12.5		Allied Corp	14.0	
Schlumberger	1.8		American Express	15.6		Dow Chemical	24.9	
Royal Dutch Petroleum	5.7		JP Morgan & Co	15.4		Union Carbide	24.3	
Mobil	2.2		American Intl Group	16.0		Monsanto	16.0	
Technology	14.7%	16.2%	Transportation	3.7%	3.9%	Utilities	11.7%	8.0%
	total return			total return			total return	
IBM	1.7%		CSX	13.6%		AT&T	12.9%	
Boeing	7.9		AMR	14.0		Nynex	13.6	
Lockheed	6.4		Burlington Northern	19.3		BellSouth	19.6	
United Technologies	2.4		Norfolk Southern	7.6		Southwestern Bell	14.7	
Digital Equipment	–9.7		Santa Fe Southern Pacific	20.9		GTE	2.2	